October 10th, 2013

Here is our newsletter for the 4th Quarter of 2013.

The Markets

The 3rd quarter saw markets rebound with U.S. and emerging market stocks up about 5% and foreign developed stocks up over 11%. Bond prices stabilized and managed a small gain of 0.5% for the Aggregate Bond Index.

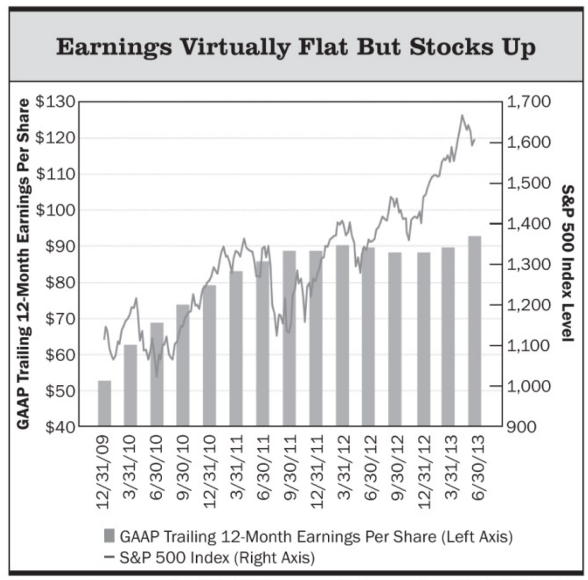

CHART 1 *Data as of 6/30/13 (estimated). Source: Standard & Poor's.*

Although we have not made any changes this year to our fund allocation, our allocation to U.S. stocks has been reduced further due to the actions of two of our fund managers. Pimco All Asset All Authority and Litman Gregory Master Alternative Strategies are a big part of our alternatives holdings and have reduced their equity exposure for several reasons. Over the past two years or so, U.S. corporate trailing 12-month earnings have gone nowhere, but the market has continued its ascent, especially over the past year (see chart). The S&P 500 now trades at 19x trailing 12-month earnings. In previous newsletters we have talked about the record level of profit margins and how these high margins always fall back to earth and we are starting to see signs of that happening. We can't justify margins staying at these elevated levels over our investment horizon, so it means we need to remain patient before we are proven right.

Taxing Relationships

With taxes going up at the beginning of the year understanding the impact of these changes on you can pay dividends. Federal income marginal tax rates have gone up for most with the top marginal income tax for high earners increasing from 35% to as much as 43.4% Capital gain taxes have also gone up depending upon your income. This time of year is a good time to do some tax planning and see how we can reduce your tax bill for 2013.

Same-sex couples got great news when the federal government indicated, due to the Supreme Court ruling striking down a key part of the Defense of Marriage Act, the ability to file their taxes as a married couple no matter where they live. All they have to do is get married in one of the 14 states that recognize same-sex marriages. There are lots of good reasons, financial and otherwise, gay advocates are happy about this. There are many advantages for married couples concerning transfer of assets, spousal rights when dealing with health care providers and other estate planning issues. One big one is the ability of the surviving spouse to rollover IRAs and other retirement plan assets into their own IRA and defers taxation on the assets over their lifetime vs. paying tax over only 5 years. Social Security is also expected to enable spousal and survivor benefits for same-sex couples which can be worth well over $100,000 for many during retirement.

One negative is potentially higher income taxes for couples with taxable income over about $150,000. Couples will have to consider this before they chose to take the plunge because when they marry they are <u>required</u> to file as married filing jointly or married filing separately. We also need to hear from Colorado and the other states concerning state taxes.

These same issues also relevant for traditional couples who need to consider all the ramifications of choosing between staying single or tying the knot. I recently met with a couple who are choosing to cohabitate based upon avoiding higher marginal income tax brackets. Unfortunately the issues go way beyond this single factor.

If phones can be smart, why not a smart Index Fund?

Using index funds is part of our strategy for managing our client's investments. We currently have four index funds in our lineup. An index fund is managed to replicate the performance of an index such as the S&P 500 or Russell 1000 index which consists of stocks of the largest U.S. companies. This passive strategy contrasts with our actively managed funds which hire a manager who tries to beat the indexes and control risk in down markets.

But not indexes and index funds are the same. For many years the dominate method in building the indexes has been to pick the companies and weight their allocation in the index by using the total value of their stock, a so-called cap-weighted index. So for example currently the total value of all the shares outstanding for Apple is $437 billion and it's weighting in the S&P 500 Index is 3.1%, making it the largest company in the world by this measure. If the price of Apple shares doubles (and the rest of the stock market was flat) the weighting of the index would double to 6.2% and the cap-weighted index funds would have to buy a lot of Apple shares to rebalance their fund to the new index weighting.

Imagine what the index weightings were back in 2000. At the time Cisco was the largest weighting along with many of the other technology titans. In early 2007 the financial sector represented about 35% of the total U.S. stock market while today it is only 15%. During each of these bubbles the cap-weighted index funds had to participate by increasing their allocation to whatever stocks had rose the most. After the crash the cap-weighted index funds had to sell those past high-flyers whenever the fund rebalanced, usually once per year.

A smarter way to build an index fund was developed by Rob Arnott with Research Affiliates. He developed Research Affiliates Fundamental Indexes (RAFI) and helped bring to market a series of mutual funds and ETFs which track his indexes starting in 2006. His Fundamental Index strategy uses a weighting structure that embodies four fundamental measures of size:

five-year averages of sales, cash flow and dividends plus current book value. You may notice earnings are not part of the equation. Current earnings are what drive stock prices up and down with Wall Street's focus on the short term and, not surprisingly, both can be highly volatile. Earnings are also more easily manipulated using creative accounting than book value, cash flow and sales.

The chart below was taken from a paper in the Journal of Portfolio Management by Arnott and others which highlights the advantage of several alternatives to cap-weighting. Taking all the factors into consideration the RAFI index strategy comes out of top. In practice the index fund we have been using for several years (PRF) has returned 1.5% more per year since its inception than the equivalent large-cap U.S. cap-weighted indexes. We anticipate we will use more of these going forward in U.S. and non-U.S. equity markets and perhaps even in his more recently developed bond indexes.

Table 1. Characteristics of Simulated U.S. Strategies, 1964-2012

US (1964-2012)	Return	Value Added	Volatility	Tracking Error	Turnover	Dec. 2012 Market Cap ($B)
Cap-Weighted	9.66%		15.29%		4.7%	$96.95
Equal-Weighted	11.46%	1.80%	17.37%	5.00%	18.7%	$15.56
Minimum Variance	11.75%	2.09%	11.69%	8.04%	48.0%	$29.87
Average of 100 Monkeys	11.26%	1.60%	18.34%	7.76%	97.5%	$15.31
RAFI	11.60%	1.93%	15.45%	4.64%	11.5%	$82.29

Source: Research Affiliates, LLC.

research affiliates

Obamacare

I recently attended a webinar on the Affordable Care Act and what employers need to know about their requirements. If you need to know more I have a Powerpoint presentation I can give you or I can refer you to one of the so-called Navigators who can help. Here is an idea for parents who have kids in their 20s and you are paying for their health insurance: get on the Colorado insurance exchange website at www.connectforhealthco.com and see if your kid can qualify for subsidized coverage. It could save you a bunch.

If you need additional information on the above or any other issues let me know.

Sincerely,

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Comprehensive Financial, Inc.
Registered Investment Advisor